ANNUAL CONFERENCE OF THE CANADIAN LAND TRUST ALLIANCE AND THE HERITAGE CANADA FOUNDATION

WORK THAT ENDURES – POWER TO THE PEOPLE KEEPING PLACES ALIVE

Quebec City – September 26, 2008

Roundtable on Reforms to Tax Incentives

By Ellen Zweibel, University of Ottawa and Karen J. Cooper, LL.B., LL.L., TEP

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Roundtable on Reforms to Tax Incentives:
Transferable Charitable Credits for Gifts of Conservation Easements

By Prof. Ellen Zweibel, University of Ottawa, Faculty of Law
and Karen J. Cooper, LL.B., LL.L, TEP

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I. INTRODUCTION

- Private lands are becoming increasingly important to the protection of Canada's environmental heritage and biodiversity
- The *Income Tax Act* ("ITA") provides favourable treatment for gifts of ecologically sensitive land and partial interests in land through the Ecological Gifts Program ("EGP")
- The EGP was introduced in 1995 as a tool for encouraging the conservation of habitat and biodiversity across Canada

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- **As of March 2008, 652 ecological gifts totalling 112,199 hectares and valued at over $379 million have been made in Canada**
- **Nearly half of these gifts contain habitats designated as having national, provincial, or regional importance, and many include rare or threatened habitats that are home to species at risk**
- **The tax benefits are substantial, similar to gifts of publicly-listed securities**

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II. BASIC REQUIREMENTS OF ECOGIFTS

- **An ecological gift is a particular type of charitable gift under the ITA and a number of specific requirements are associated with ecological gifts**
- **For donors to receive the tax benefits of an ecological gift, the ITA imposes the following requirements:**

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1. Eligible Recipient:

- **Territorial, provincial or federal departments or agencies**
- **A municipality**
- **An approved registered charity whose main purpose is the conservation and protection of the environment**

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2. Ecologically Sensitive Land:

- **The land, including a servitude, covenant or easement, must be ecologically sensitive and its conservation and protection important to the preservation of Canada's environmental heritage**
- **Environment Canada has developed a definition of "ecologically sensitive land," which is based on national, provincial or territorial criteria that are outlined in *The Canadian Ecological Gifts Program Handbook 2005* and updated on the Environment Canada website**
- **The Minister of the Environment, or his designate, will issue a *Certificate for Donation of Ecologically Sensitive Land* (or, in Quebec, a *Visa pour dons de terrains ou de servitudes ayant une valeur écologique*)**

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3. Certified Fair Market Value:

- **The fair market value ("FMV") of the gift must also be certified**
- **The FMV of an easement, covenant or servitude may be determined using the "before and after" method of valuation, e.g. the FMV of the gift is the value of the land before the grant minus the FMV of the land after the grant**
- **The donor must submit an independent appraisal of the FMV of the donation to Environment Canada, along with a signed application form**

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- **The appraisal is reviewed by the Appraisal Review Panel, which makes a recommendation of FMV to the Minister of the Environment**
- **The Minister then determines the FMV**
- **The donor may accept the Minister's determination of FMV or seek a redetermination by the Redetermination Committee of the Appraisal Review Panel**
- **The Minister then either confirms the value previously determined or redetermines the value, taking into account the recommendation of the Redetermination Committee**
- **If the donor still does not agree, the donor may appeal to the Tax Court of Canada (within 90 days)**

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III. TAX BENEFITS

- **Some of the tax benefits of an ecological gift are the same as for all gifts:**
  - **Individual donors receive a non-refundable tax credit**
  - **Corporate donors deduct the amount directly from their taxable income**
  - **Any unused portion of the donor's ecological gifts may be carried forward for up to five years**

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- **Ecological gifts also benefit from tax benefits which are more significant and similar to those available for gifts of publicly listed securities:**
  - **The taxable capital gain realized on disposition of property is nil**
  - **The upper donation limit has been removed**

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IV. FOCUS ON CONSERVATION EASEMENTS

- **Fastest growing voluntary land conservation tool**
- **Presents more practical and policy challenges than straight out land donations**

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1. **Conservation Easements - Basics**

- **Popular name for a binding agreement between a landowner and a charity or government entity which restricts future land development in favour of specific conservation goals. Includes easements, servitudes, restrictive covenants.**
- **Restrictions are tailored to meet environmental goals and landowner's circumstances.**
  - **Prohibit or limit subdivision and new building construction, restrict pesticide use near watersheds, require grassland maintenance.**
  - **Working easements allow farming, ranching and small scale wood lot production as long as they don't conflict with the conservation goals**

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- **Special provincial legislation required to overcome common law constraints that inhibit creation and enforcement**
- **Ecogift donations must restrict the land use "in perpetuity" regardless of who owns the underlying land**
- **"Before and After" method of valuation**

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2. **The Conservation Easement "Explosion"**

- **Fastest growing voluntary land conservation tool**
- **In Canada approximately half of all ecological gifts to date have been conservation easements**
- **In United States between 2000 - 2005**
  - **Conservation Easements up 148%**
    - **(Increased from 2.5 mil to 6.2 mil acres held)**
  - **Land holdings up only 40%**

3. Why Conservation Easements are Popular?

a) Cheaper to purchase – This is important if the landowner donating an easement needs some compensation from the acquiring charity

b) Flexible – Can preserve the land's productive economic use, keep the land in the local property tax land base and ensure the land's significant ecological values are protected

c) Landowners often prefer to retain their personal use so that the conservation easement is the only way to curtail future development

d) Efficient allocation of costs and responsibilities. Ownership costs, such as maintenance and insurance remain with the landowner, leaving the task and costs of monitoring the conservation attributes to the conservation charity's expertise and expense

4. Conservation Easement Challenges

- Conservation Easement donations generally raise more practical and policy concerns than straight-out land donations
- US literature abounds with "reform" oriented criticism
  - Uncertain conservation values, uneven quality, success measured in acres without quality assessment
  - Accepted by organizations with poor stewardship capabilities, engaging in self-dealing or conflicts of interest
  - Lax recordkeeping, monitoring and enforcement
  - Undemocratic land use planning, ad hoc "green sprawl"

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- **Abusive transactions:**
  - **Overvalued (Colorado reports $15 million sought in tax credit repayments on bad transactions)**
  - **Subdividing to create multiple easements**
- **Low conservation values:**
  - **Outside the "spirit" of the credit**
  - **Golf courses**
  - **Amenities for wealthy subdivisions**

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V. EXAMPLE: Donation of a Conservation Easement

Jack has been involved in mixed farming on a couple of sections of land in the aspen parkland region of Saskatchewan for the last 32 years. Although much of this land, which has been in his family for several generations, is in cultivation or used as hay land, two quarter sections remain in their original native prairie condition and include several aspen bluffs and wetlands. Ducks, geese, and other wildlife are abundant on these lands. Jack presently uses these native quarter sections for grazing cattle. He takes special care to manage his land in an environmentally sustainable manner.

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In speaking with a local environmental group about proper habitat stewardship practices, he heard about the Ecological Gifts Program. He decides to give the group a conservation easement on the two native quarter sections of land to protect the land from cultivation while maintaining moderate grazing as a sustainable management tool. The two quarter sections are in a urban - rural area where there is significant development pressures.

The land originally cost $100,000 and is now worth $1,250,000. With the easement, the land is valued at $250,000.

Jack's annual income is $40,000.

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Environment Canada has certified that the land meets its criteria regarding ecological sensitivity and that the FMV is $1 million:

Capital gain from transfer	$920,000
Taxable capital gain	$0
Self-employment income	$40,000
Taxable income	$40,000
Income tax payable (Federal and Provincial)	$10,000
Claim eligible amount	$22,800 ($977,200 remains for future use)
Donation tax credit	$10,000
Net tax payable	$0

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Jack's Tax Incentive:

- **Jack has received relief from capital gains**
- **He has not paid tax this year**
- **If he continues to earn $40,000 a year he will not pay tax for the next 5 years**
- **He will have $863,200 donated value that expires after 6 years**

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VI. TAX POLICY EVALUATION

1. Tax Incentives:

- **Tax incentives are indirect government spending in the form of tax revenues foregone**
- **Ecogift tax incentives support private philanthropic decisions and activities**
- **Before we propose tax changes we need a policy framework and criteria against which we measure a proposed tax spending initiative**

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2. Discussion: What do we want to achieve?

- **What do we want to achieve through ecogift tax policy reform?**
- **Your thoughts: Flip chart**

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Our thoughts:

1. Environmental Effectiveness:

- **Desired ecological objective: Protect conservation values by increasing quality easement donations**

2. Economic Efficiency:

- **Correct a market failure: The low recognition of conservation values in the economy, particularly in land use decisions**
- **At the appropriate price: Ensure fiscal responsibility**
- **With minimum transaction and compliance costs**

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3. Equity or Distributional Impacts

- **Who is paying? Who is benefiting? Regional disparities?**
- **Which generation gets the benefits and which bears the costs?**

4. Flexibility and Political Feasibility

- **Will this be sufficiently responsive to future needs?**
- **Will this sell politically?**
  - **Cost, Accountability, Easy to administer, Transparent**
  - **Consistent with other values - Philanthropy**

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VII. THE U.S. EXAMPLE

- US Federal: Qualified Conservation Contribution
  - Charitable Deduction (itemized)
  - Higher contribution levels than other charitable gifts of property (50% of Adjusted Gross Income)
  - Longer Carry forward period - 15 years
- US State Income Tax: Most states mirror Federal
  - 13 States allow Non-Refundable Tax Credits
  - Longer Carry forward periods (10, 15, 20 years)
  - 3 States allow Transferable Credit
  - 1 State allows Refundable Credit

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1. Transferable and Refundable Credits: A New Approach to Stimulating Conservation Donations

- Colorado, Virginia, South Carolina - allow donors to sell their state income tax conservation tax credits to another taxpayer who then uses the credit to pay their own taxes
- Colorado provides a Refundable Credit (direct payment by the State of credits in excess of taxes owed up to $100,000 max) . But only in budget surplus years
- Other states are studying the credit transfer approach - Massachusetts

- Preliminary research suggests transferable credits with certain features significantly stimulates the pace of conservation easement donations
- Virginia, South Carolina and Colorado all had large jumps in the number of easement donations when credits were made transferable and credit amounts increased
- Colorado easement donation tax credit claims jumped from 2.3 million in 2001 to 85.1 million in 2005. Credit transfer was introduced in 2003. Five Hundred sales of tax credits happen each year.

2. How Does Tax Credit Transfer Work?

- **Donor calculates their available tax credit under the limitations defined by each state**
- **Donor sells a percentage of the tax credit and receives a cash payment today. The state may limit the percentage that can be sold.**
  - **Cash payment range from 70-82% of the credit sold**
- **Purchasers buy credits at a discount**
- **Third party broker usually facilitates – fee**

- **Credits that might otherwise never be used by the donor can now be claimed by credit purchasers**
- **Donors without sufficient income to claim a full tax credit get some additional financial value for making the contribution**
- **Credits that might otherwise expire because the donor can't use them up in the carry forward period can now be fully used by another taxpayer**

3. Each State has Unique Provisions

- **State Income Tax Rates are relatively low.**
- **Easements often have high appraisal values could generate significant credit amounts.**
- **States limit the tax credit and transferability through:**
  - **Calculating credits as a % of FVM (25%-100%)**
  - **Overall dollar caps on credits ($10,000 to $375,000)**
  - **Per easement $ limits; # of easements allowed**
  - **Annual limits**
  - **Limits on amount transferable**

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4. Example: Colorado

- **Why Colorado?**
  - **Transferable credit**
  - **Long carry-forward**
  - **Refundable credit**
  - **History of questionable transactions**
  - **Frequent amendments to address abuse**

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- **Basic description**
  - **The conservation easement credit is based on the FMV of the easement**
  - **The total tax credit allowed for any one easement donation is 50% of the FMV up to a maximum of $375,000 . In effect, Colorado caps the eligible amount of the donation at $750,000**
  - **Any unused state conservation tax credits may be carried forward for 20 years**
  - **In budget surplus years, taxpayers can receive a tax refund up to $50,000**

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- **Assume a Colorado approach in Canada: what happens with Jack's taxes (no transfer)?**
  - **FMV of the donated easement is $1million**
  - **Maximum per easement value that can be claimed, is in effect $750,000**
  - **Carryforward period is 20 years**
  - **Jack could eliminate 21 years of taxes and would be using $478,800 of the donation value leaving him with $271,200 unused donation value**

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- What if the tax credit was refundable?
  - In Colorado there needs to be a budget surplus: only 2000, 2001 and 2005
  - Refundability is limited to $50,000 credit
  - Jack would use $10,000 to eliminate tax and would get a $40,000 refund
  - With refundability and a 20 year carryforward, Jack would likely use the entire donation amount

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- Assume Jack wants cash now?
  - Jack sells $400,000 of his donated value for $320,000
    - Should the $320,000 be taxed?
    - US position – Taxed as ordinary income
  - Jack still has $350,000 for his own use

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Assume a Colorado approach in Canada. What happens with Jack's taxes with transfer?

Income from credit sale	$320,000	
Self-employment income	$ 40,000	
Taxable income	$360,000	
Income tax payable (Federal and Provincial)	$165,600	
Claim eligible amount	$350,000	($0 remains for future use)
Donation tax credit	$153,965	
Net tax payable	$ 11,635	

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Assume a Colorado approach in Canada. What happens with Jack's taxes with transfer?

- **Jack has land now worth only $250,000**
- **Jack has obligations to a land trust**
- **Jack has a working farm**
- **Cash $320,000 plus $40,000 self employment**
- **Tax liability of $ 11,635**

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Tax Policy Issue: How much will the government be willing to spend?

- **Under the current system over 6 years, using Jack's donation example Government spent in foregone taxes … $60,000**
- **Using our transfer example the Government would spend**
- **$350,000 of donation value was used by Jack to reduced his taxes by $153,965**
- **$400,000 used by the purchasing taxpayer which reduced taxes by $ 184,000**

Total revenue forgone is now $337,965

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VII. IS CREDIT TRANSFERABILITY A GOOD FIT FOR CANADA?

Pragmatic:

- **Can the current system handle it?**
- **Would it achieve important environmental goals or just create new problems?**
- **New tax questions arise: Taxing the credit sale itself?**
- **What other tax measures could achieve the goals?**
- **What about a more modest extend carryforward**

Philosophical:

- **Commercializing charitable giving**
- **What are the intangible effects on our values?**

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